No. 91-628

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1991

CHARLES S. and BARBARA LERMAN, ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, under Section 108(b) of the Deficit Reduction Act of 1984, as amended by Section 1808(d) of the Tax Reform Act of 1986, a commodities dealer may deduct putative "losses" incurred from participation in sham commodity "straddle" transactions lacking economic substance.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A34) is reported at 939 F.2d 44. The opinion of the Tax Court (Pet. App. A38-A54) is unofficially reported under the caption *Fox* v. *Commissioner*, 56 T.C.M. (CCH) 863.

JURISDICTION

The judgment of the court of appeals (Pet. App. A35-A37) was entered on July 18, 1991. The petition for a writ of certiorari was filed on October 15, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. During 1975, 1976, and 1977, petitioners, who were assumed to be commodities dealers for purposes of the respondent's motion for summary judgment, participated in commodities tax straddle transactions on the London Metal Exchange.[1] Petitioners' transactions were designed to yield putative "losses" in the first year and offsetting "gains" in the next. By straddling the tax "losses" and "gains" over the two years, the objective was to derive tax benefits from transactions wholly lacking in economic substance. Because these transactions lacked economic substance, the Commissioner disallowed the deductions resulting from the claimed "losses," and the Tax Court upheld that determination.[2] Petitioners now acknowledge (Pet. 13; Pet. App. A3-A4) that the transactions for which they claim deductions were arranged solely for

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[1] Mrs. Lerman, Mrs. Fraites, and Mrs. Massey are petitioners only because they filed joint returns with their husbands (Pet. App. A41). Mr. Lerman, Mr. Fraites and Mr. Massey are hereinafter referred to as petitioners.

[2] Petitioners stipulated that their transactions were of the same type as the London option commodity straddle transactions held to be shams, devoid of economic substance, in *Glass* v. *Commissioner*, 87 T.C. 1087 (1986). *Glass* is the caption of some 1400 consolidated cases, and decisions in those cases have been affirmed by all of the courts of appeals that have considered them. *Dewees* v. *Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Friedman* v. *Commissioner*, 869 F.2d 785 (4th Cir. 1989); *Killingsworth* v. *Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988); *Kielmar* v. *Commissioner*, 884 F.2d 959 (7th Cir. 1989); *Lee* v. *Commissioner*, 897 F.2d 915 (8th Cir. 1989); *Keane* v. *Commissioner*, 865 F.2d 1088 (9th Cir. 1989); *Bohrer* v. *Commissioner*, 945 F.2d 344 (10th Cir. 1991); *Kirchman* v. *Commissioner*, 862 F.2d 1486 (11th Cir. 1989).

the purpose of generating putative tax losses and thus lack economic substance. See *Glass* v. *Commissioner*, 87 T.C. 1087, 1153-1178 (1986); note 2, *supra*.

2. Taxpayers contend, however, that as commodities dealers, they are entitled to deduct the putative "losses" even though the transactions lacked economic substance. Petitioners' claim is based upon Section 108 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630, as amended by Section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2817-2818. As amended, Section 108(a) provides that losses attributable to the disposition of one leg of a commodity straddle are deductible if incurred in a "trade or business" or in a "transaction entered into for profit." Section 108(b), as amended, provides that a "loss incurred by a commodities dealer * * * shall be treated as a loss incurred in a trade or business" (Pet. App. A4).

The Tax Court held that even though petitioners were presumed under Section 108 to be engaged in a "trade or business" as commodities dealers, Section 108 does not allow "losses" to be deducted when they are incurred in prearranged transactions that lack economic substance (Pet. App. A50-A51). Since offsetting gains had been prearranged, the court held that "petitioners' straddle transactions produced no losses to which the per se rule of section 108(b) can be applied." (Pet. App. A51). Because there were no "losses," Section 108(b), which applies only to "any loss" incurred by a commodities dealer, is not applicable (Pet. App. A4). This conclusion was supported by the legislative history of Section 108, which reflects that a deduction for losses incurred by dealers "would not be available in any cases where the trades were fictitious [or] prearranged" (Pet. App.

A50) (quoting H.R. Rep. No. 426, 99th Cong., 1st Sess. 911 (1985).

3. The court of appeals affirmed. The court agreed with the Tax Court that since the London option transactions were prearranged solely to generate tax benefits in the form of deductible losses, the transactions lacked economic substance and could not be recognized for tax purposes (Pet. App. A24). The court of appeals further held that Section 108 "cannot be applied to transactions lacking in economic substance because, in tax terms, a transaction lacking in economic substance cannot result in a 'loss'" (*ibid.*). Since there was no "loss," the court held that "section 108 does not even come into play" (*ibid.*). The fact that the transaction involved a commodities dealer was "neither a logical nor a statutorily-authorized reason to alter the economic substance rule" (Pet. App. A25). While noting that Congress, in amending Section 108(b), was willing to give up some tax revenue from straddle transactions due to the difficulty in proving a dealer's subjective profit motive, the court of appeals stated that (Pet. App. A30-A31):

> This * * * is a far cry from saying that Congress intended to allow dealers to take deductions based on straddle transactions totally devoid of any purpose beyond the generation of tax deductions and passed a statute by which there would be absolutely no inquiry into the substantial tax validity of such transactions.

The court further noted (Pet. App. A25-A29) that both the Ninth and Second Circuits had reached the same conclusion in *Cook* v. *Commissioner*, 941 F.2d 734 (9th Cir. 1991), cert. denied, No. 91-43 (Oct. 7, 1991), and *De Martino* v. *Commissioner*, 862 F.2d 400 (2d Cir. 1988).

ARGUMENT

The court of appeals correctly held that petitioners are not entitled to deduct their purported commodity tax straddle losses because these transactions lack economic substance. This decision does not conflict with any decision of this Court or of the other courts of appeals. Further review therefore is not warranted.

1. This Court has long held that transactions that lack economic substance will not be recognized for tax purposes. *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935). When a transaction represents "nothing more than a contrivance" in a scheme of tax avoidance, it will not be given effect. *Ibid.* Congress did not depart from this fundamental tenet of tax law in enacting Section 108(b).

As originally enacted, Section 108(a) provided that a loss on a straddle position was deductible if it was "part of a transaction entered into for profit" (Pet. App. A16 n.7). Section 108(b), in turn, provided dealers with a rebuttable presumption that their positions were profit motivated (*ibid.*). The Commissioner was thus free to introduce evidence to show that dealers did not have the requisite profit motive. In the Tax Reform Act of 1986, however, Section 108(a) was amended to provide that a loss on a straddle position is deductible if the loss is incurred either in a "trade or business" or in a transaction "entered into for profit" (Pet. 3-4). Section 108(b) was similarly amended to provide that "any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business" (*ibid.*). The purpose of the amendment was to eliminate the need for the "inherent[ly] difficult[]" inquiry into the profit motive

of dealers for trades executed in the course of their customary business (H.R. Rep. No. 426, *supra*, at 910-911). The report of the House Ways and Means Committee makes clear, however, that, contrary to petitioners' contention (Pet. 16-37), Congress never intended that dealers who engage in straddle transactions that lack economic substance would be entitled to avail themselves of the provisions of Section 108(b). The report states (H.R. Rep. No. 426, *supra*, at 911):

> [T]he presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member.

In light of this explicit expression of congressional intent, petitioners' argument that Congress meant to allow dealers to deduct putative losses from commodity trades where such transactions were prearranged to result in nothing more than tax losses is clearly without merit, and the courts of appeals have consistently rejected petitioners' contention. See *Cook* v. *Commissioner*, 941 F.2d at 738; *De Martino* v. *Commissioner*, 862 F.2d at 407. In enacting Section 108(b), Congress did *not* intend to give dealers a carte blanche to deduct artificial losses from commodity straddles that were, in substance, economic illusions. *Cook* v. *Commissioner*, *supra*; *De Martino* v. *Commissioner*, *supra*.

Petitioners err in contending (Pet. 41) that the court of appeals held that their trades lacked economic substance because they had no profit motive. The question whether a transaction has economic substance does not depend upon a subjective analysis of the taxpayer's motive but, instead, upon an objective analysis of whether the transaction has an economic

effect *other than* avoiding taxes. See *Gregory* v. *Helvering*, 293 U.S. at 469-470. Neither the Tax Court nor the court of appeals based its decision in this case on the absence of any profit motive on the part of the investors. Instead, the courts held that the transactions, viewed as a whole, were designed and executed to produce nothing other than tax benefits (Pet. App. A22, A23, A48).

Petitioners' further contention (Pet. 45-46) that the use of the word "prearranged" in H.R. Rep. No. 426, *supra*, "means 'fake' or 'phoney' trades or trades violative of the rules of the exchange" is simply wrong. If the Ways and Means Committee believed that a transaction that is prearranged is necessarily "fictitious", its application of the statute to trades that are either "fictitious, prearranged, or otherwise in violation of the rules of the exchange" (H.R. Rep. No. 426, *supra*, at 911) would have been unnecessary. The Committee evidently intended that Section 108(b) would be unavailable with respect to any transaction that lacks any real economic significance, whether because it is a factual sham or because it was prearranged to have no substantive effect other than the creation of tax benefits. See *Cook* v. *Commissioner*, 90 T.C. 975, 994 (1988) (Wells, J., concurring).

2. As petitioners apparently concede (Pet. 11), the decision in this case does not conflict with any decision of this Court or of any other court of appeals. Indeed, the only other courts to have considered this question have reached the same conclusion—that Section 108(b) does not allow a "loss" deduction for transactions that lack economic substance. See *Cook* v. *Commissioner*, 941 F.2d at 738; *De Martino* v. *Commissioner*, 862 F.2d at 407. In *Cook*, in which this

Court recently denied certiorari, the taxpayers had "invested" in the same type of London option straddle transactions at issue here. Because such trades involved a prearranged plan to create tax losses without any possibility that any genuine gain or loss would be realized, the court of appeals correctly concluded that they lacked economic substance and are not recognized for tax purposes. 941 F.2d at 736-737. Similarly, the Second Circuit held in *De Martino* that, in enacting Section 108(b), "Congress eliminated the profit motive inquiry in cases involving dealers because of the inherent difficulty involved in making such an inquiry, but it did not prevent inquiry into the economic substance of a dealer's commodity trading." 862 F.2d at 407.

The decision in this case also is consistent with numerous decisions holding that Section 108(a) has no application to commodity transactions that lack economic substance because no genuine "loss" has occurred. See, *e.g.*, *Keane* v. *Commissioner*, 865 F.2d 1088, 1093 (9th Cir. 1989); *Friedman* v. *Commissioner*, 869 F.2d 785, 791 (4th Cir. 1989); *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1494 (11th Cir. 1989); *Killingsworth* v. *Commissioner*, 864 F.2d 1214, 1218 (5th Cir. 1989); *Ratliff* v. *Commissioner*, 865 F.2d 97, 99 (6th Cir. 1989). See also *Dewees* v. *Commissioner*, 870 F.2d 21, 36 (1st Cir. 1989). Further review therefore is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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